

**REFORM PROGRAM FOR THE WATER SECTOR AND
THE POTABLE WATER AND SANITATION SUBSECTOR**

(ES-0068)

EXECUTIVE SUMMARY

BORROWER AND GUARANTOR:	Republic of El Salvador
EXECUTING AGENCY:	Comisión Coordinadora para la Reforma Sectorial de los Recursos Hídricos [Coordinating Committee for Restructuring of the Water Resource Sector] (COSERHI) (see paragraphs 3.2 and 3.3); Administración Nacional de Acueductos y Alcantarillado (ANDA) [National Water and Sanitation Administration] (see paragraph 3.5); Ente Rector para la Administración de los Recursos Hídricos [Water Resources Authority (the Authority)] and Agencia de Regulación de los Servicios de Agua Potable y Alcantarillado (ARESA) [Water and Sanitation Regulatory Agency] (see paragraph 3.4).
AMOUNT SOURCE:	AND IDB Loan (OC):US\$43.7 million IDB nonreimbursable TC (FSO):US\$ 1.5 million MIF Donation:US\$ 2.4 million <u>Local counterpart:</u> To IDB (OC) US\$11.3 million To IDB TC (FSO) US\$ 0.2 million To MIFUS\$ 0.9 million Total: US\$60.0 million
FINANCIAL TERMS AND CONDITIONS:	Amortization period:20 years Disbursement period:4 years Interest rate:variable Inspection and supervision:1% of the loan amount Credit fee:0.75% Currency: US\$ (Single Currency Facility)
OBJECTIVES:	<p>The overall objective of the program is to foster and encourage structural reforms in the water resource sector, and the water and sanitation subsector, in order to: (i) promote conservation and more rational and efficient use of water resources; and (ii) create an institutional and business environment that will invite public and private investment in water and sanitation services.</p> <p>The specific goal is to restructure management mechanisms in the sector and subsector by: (i) creating a financially independent water authority responsible for oversight and policy-making to ensure proper development and preservation of the resource, with the necessary technical capacity, studies and instruments for integrated management of water resources and rational allocation of water rights; (ii) establishing a regulatory framework for the water and sanitation subsector, and an independent and financially autonomous regulatory agency equipped with the necessary instruments for enforcing regulations enacted to govern the provision of services; and facilitating and promoting</p>

competition and transparency at all levels among water and sanitation service providers; and (iii) supporting commercial restructuring in the sector, with the creation of more efficient and financially viable public, private, and semi-private operators of water and sanitation services, and programs to expand and improve the quality of services.

DESCRIPTION:

The program will have three components, in addition to support for Program execution and coordination: (i) restructuring of the water resource sector; (ii) establishment of the regulatory framework for the water and sanitation subsector; and (iii) commercial restructuring of the subsector under two subcomponents: support for management reorganization and related investments.

1. Component 1: Restructuring of the water resource sector (US\$6.8 million): Support for initial organization of the governing body in charge of water resources ("the Authority"), and development of the regulatory framework for the sector. This will include: (i) technical assistance and specialized consultancies; (ii) strategic studies in areas such as the water balance, the San Salvador aquifer, and the economic instruments for allocating water rights, as well as for a community participation project in a pilot catchment basin; (iii) support for the institutional structure and operations of the sector's governing body; and (iv) modernization of the hydrometeorology information system.

2. Component 2: Establishment of the regulatory framework for the water and sanitation subsector (US\$4.1 million): Support for formulating the subsector's legal and regulatory framework and legislation, and the organization and placement in operation of its regulatory agency (ARESA). This will include: (i) technical assistance and specialized consultancies to help formulate the regulatory framework; (ii) strategic studies in areas such as tariff rates, subsidization policies and technical standards updating; and (iii) support for creation and start-up of ARESA.

3. Component 3: Commercial restructuring (US\$39.1 million): Support for planning and establishment of independent, commercially viable companies to provide water and sanitation services. This component is divided into two subcomponents: (a) organization of commercial operations (US\$4.1 million); and (b) related investments (US\$35 million).

Organization of commercial operations will include: (i) technical assistance and support for creation of the Unidad de Reforma Empresarial [Commercial Restructuring Unit] (URE); (ii) preparation of the restructuring plan to determine the most efficient operational structure for El Salvador's water and sanitation subsector, and formulation of a strategy for effective organization, separation and/or transfer of the various commercial operating units under a program of devolution and decentralization of services with private sector participation; and (iii) promotion of such private sector participation (PSP) using specialized consultants to give support and financial advice to the government towards the effective organization of PSP schemes.

The related investments are to be financed from a commercial restructuring support fund. Eligible investments will include: (i) those

meeting the investment priorities criteria; (ii) those for rehabilitation and regularization of systems in the process of devolution and/or decentralization; (iii) investments in support of rural systems independently managed by local communities; (iv) activities in support of the formation and organization of companies providing organizational, training, commercial management, legal and other services; and (v) activities in support of worker training and retraining.

Preparation of the commercial restructuring plan and efforts to promote private sector participation will be financed by the MIF. In addition, part of the technical assistance for the URE, under the commercial restructuring component (Component 3), will be financed with local funds provided as counterpart to the MIF contribution. The MIF will also finance the technical assistance and priority studies for establishment of the regulatory framework (Component 2). The breakdown for this non-reimbursable technical cooperation operation is included in Annex II of this document.

The nonreimbursable technical cooperation funds from the FSO will finance part of the activities involved in promoting and organizing rural investment schemes (Component 3). This operation is described in Annex III of this document.

**ENVIRONMENTAL/
SOCIAL REVIEW:**

Paragraphs 4.3 to 4.6 contain a summary of the environmental and social aspects of the operation. A specific review will be conducted as part of the assessment of compliance with program conditionality to verify that the environmental and social criteria have been incorporated in the regulatory frameworks developed for both the water resource sector as a whole, and the water and sanitation subsector. Implementation of the environmental management plan, whose conditions must be met by all investment activities under the program, will also be verified, including the adoption of participatory methods and support for the role of women in rural investment schemes.

RISKS:

This program faces the risks inherent in any reform process, namely:

1. A pre-election political climate and the difficulty of getting laws passed by the Legislative Assembly. The presidential election will take place in March 1999, and the new government will take office the following June. Nevertheless, there is clear political will on the part of the government to begin the process of restructuring and lay a solid foundation for the reforms. Authorities are likewise confident that the laws will be passed by mid-1998, and that the water sector authority and regulatory agency will have been created. By early next year the alternatives for commercial restructuring will have been developed as well, as part of the commercial restructuring plan to be financed by the MIF, and this will pave the way for agreements and commitments to start the reform process.

The COSERHI has already consulted with various political parties and civil society groups concerning the reforms and reports that they have been well received and that there is general consensus on their objectives and principles. There is also the precedent of successful reforms in the electricity and telecommunication sectors. While these

encountered the difficulties hindering passage of any law by a politically divided Assembly, there were no signs of opposition to the reform objectives ? only to the process of implementation. The process must therefore be sufficiently flexible and fluid to accommodate different approaches, without compromising the objectives.

2. Institutional weaknesses within ANDA, the municipal governments, and the regulatory frameworks to be created. To deal with this unavoidable circumstance, the program will provide the necessary resources and technical assistance until the regulatory frameworks are consolidated and sufficient demand has been generated for decentralization and private sector participation.

3. Financial matters and rates. These are of crucial importance and it is vital that political pressure for the application of rate adjustments be reduced to a minimum. The formulation of an appropriate pricing policy and the implementation of economically and financially sound rate schedules are among the most important conditions for disbursement under the program. It will also be important to develop flexible mechanisms for private sector participation. The Bank's private sector window could play an important role in this area by facilitating implementation of the recommended PSP schemes.

4. Uncertainty concerning effective participation by the private sector and municipalities. This risk depends upon the country's political, economic, and social climate. The regulatory and promotional activities to be carried out under this program are intended to create a favorable legal and institutional framework, which will help to lower this risk. In addition, decentralization and private sector involvement have clearly taken on a momentum of their own in El Salvador.

BENEFITS:

This program will bring institutional order to the water sector and create a favorable environment for more efficient and modern management of the water resource sector as a whole, as well as the water and sanitation subsector. It will pave the way for private sector participation and decentralization, thereby opening up the sector, attracting higher levels of investment, and improving the coverage, quality, and efficiency of service throughout the country. The regulatory framework established will make it possible to monitor the quality standards to be met by the service providers and for this information to be disseminated to the public to encourage the participation of consumers in the protection of their rights. Resolving the water supply problem will have a positive impact on public health, environmental, and quality-of-life indicators in El Salvador.

THE BANK'S COUNTRY AND SECTOR STRATEGY:

This program is consistent with the strategy adopted by El Salvador and the Bank for public service modernization and restructuring, encouraging private sector participation and decentralization in order to improve the coverage and quality of such services.

POVERTY- TARGETING:

The program does not specifically target low-income groups; rather, it aims to bring about sector reform at the national level. However, given the nature of El Salvador's water supply system, reaching the program targets should benefit the poorest population, which is most affected by the inadequate coverage and deficient quality of potable water services

and sanitation. A positive impact is also anticipated for low income groups from the investments in support of commercial restructuring, which is directed toward medium-sized and small towns and rural areas (see paragraph 4.25).

**PROCUREMENT OF
GOODS AND
SERVICES:**

Bank procedures shall be used to procure the works, goods, and services under this program. Nonetheless, once the executing units have been sufficiently strengthened and trained, the implementation of ex post procedures for competitive bidding will be gradually tested. International competitive bidding will be required to procure goods worth US\$250,000 or more and works valued at US\$1 million or more. In the case of consulting services, international bidding is required for contracts valued at US\$200,000 or more. Competitive bidding for contracts below these thresholds will be conducted in accordance with the provisions of paragraph 3.33.

**SPECIAL
CONTRACTUAL
CONDITIONS:**

Conditions precedent to the first disbursement of the loan:

1. Submission to the Legislative Assembly of the bill to establish the Authority ("the Water Resources Authority Act") (see paragraph 3.12).
2. Submission to the Legislative Assembly of the bill governing the regulatory framework of the potable water and sanitation subsector, and establishing the Water and Sanitation Regulatory Agency ("ARESA Act") (see paragraph 3.12).
3. Creation of the Commercial Restructuring Unit (URE) under the Office of the Chairman of ANDA, staffed with the specialized personnel needed to begin its activities (see paragraph 3.12).
4. Selection of a consulting firm to carry out the commercial restructuring study (with MIF financing), based on terms of reference previously agreed upon with the Bank (see paragraph 3.12).
5. Entry into force of the Operating Regulations, including specifications of the plan of operations and the environmental management plan, for the related investments under Component 3 (see paragraph 3.12).
6. Signature of an agreement for transfer from the the borrower to ANDA of the loan and local counterpart resources necessary to execute the commercial restructuring subcomponents under the responsibility of ANDA. The loan resources will be transferred under conditions similar to those established in the loan contract with the Bank, and the local counterpart resources will be transferred as a capital investment (see paragraph 3.28).
7. The executive decree expanding the authority and functions of COSERHI has entered into force, and the borrower has reported that this Commission has the legal capacity to execute the activities assigned to it under this Program (see paragraph 3.3)

Fulfillment of these conditions will allow access to all loan resources intended for: (i) support of the executing agency (COSERHI/UCM); (ii) Component 1; (iii) Component 2; and (iv) Component 3 in the following manner: up to US\$8 million for priority investments in accordance with investment plans agreed upon with the Bank; up to US\$1.6 million for investments in rural systems; and up to US\$1.5 million to support the organization and work of the URE (see paragraph 3.13). The studies to be financed by the MIF contribution will have begun earlier with the creation of the URE.

Conditions precedent to the first disbursement for investments in support of commercial restructuring under Component 3 (the remainder of the loan resources):

1. Entry into force of the Water Resources Authority Act and the

regulatory framework for the water sector, including at a minimum that: (i) The Authority is operating in accordance with the provisions agreed to with the Bank and has the legal capacity to execute Component 1; (ii) regulations have been promulgated under the act; and (iii) the criteria for allocating water rights have been determined, including environmental requirements (see paragraphs 3.14, 3.15, 4.3 and 4.4).

2. Entry into force of the ARESA Act and the regulatory framework for the water and sanitation subsector, including at a minimum that: (i) ARESA is operating in accordance with the provisions agreed to with the Bank and has the legal capacity to execute Component 2; (ii) regulations have been promulgated under the ARESA Act and evidence is submitted showing that the law amending the act creating ANDA has also entered into force; (iii) the regulations governing contracts for provision of services, including the respective environmental considerations, have been approved; and (iv) a new rate schedule and policy for water and sanitation services has been implemented, along with the policy on subsector subsidies and development (see paragraphs 3.14-3.16, 4.3 and 4.4).
3. As previously agreed with the Bank, evidence that the tender calls for water and sanitation services under the private sector participation (PSP) modality have been published and a plan submitted for independent and decentralized operation of such services based on the commercial restructuring study (see paragraphs 3.14 and 1.32).

Other special conditions:

1. The following must be submitted during the first quarter of each calendar year during program execution: (i) a financial statement, together with a projection of ANDA's financial flows for the year to ensure that ANDA has sufficient funds to operate and meet its financial obligations (see paragraph 4.12); and (ii) evidence that the costs of the investments made in commercial restructuring of the autonomous water and sanitation service providers are being recovered under financial conditions substantially similar, at a minimum, to those of the Bank's loan (see paragraph 3.30).
2. In addition to the usual conditions precedent to the first disbursement, the loan contract shall contain the rest of the Bank's standard conditions for this type of operation, as well as its conditions governing audits, reports, periodic meetings, inspections, maintenance, the procurement of goods and services, and the hire of consulting services.

**RECOGNITION OF
PRIOR EXPENSES:**

The Bank may recognize, as part of the financing and local counterpart, outlays for investment in designs, studies, and program activities. Expenses up to US\$1.2 million equivalent incurred during the 18-month period prior to the date of loan approval will be recognized as part of the local counterpart (see paragraph 3.34).

